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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 177

MARY E. WENGER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On petition for a writ of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

REPLY BRIEF FOR PETITIONER IN SUPPORT

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Error in the Petition

At page 4, line 21, for "1934" read "1932."

Argument

I.

In the brief for respondent, at page 6 it is stated that the petitioner's contention is that the trustee has a substantial adverse interest sufficient to render Section 166 of the Revenue Act of 1934 inapplicable. In fact the petitioner contends that the trustee's interest was also sufficient to render Section 167 of that Act inapplicable.

Section 166 concerns corpus of the trust only, and Section 167 concerns income only.

(For the Revenue Act of 1934, see 48 Stat. 680. Sections 166 and 167 are set forth in full in the record at p. 63, and the pertinent parts in brief for respondent pp. 9, 10.)

If this contention is sustained, the court below was in error in holding the petitioner taxable on one-half of the income from the trust (Respondent's brief, p. 6, note 1) as well as in holding Section 166 applicable.

Distributions of income and corpus are controlled by Section G of the trust instrument (R. 42, 43; set out in the brief in support of the petition pp. 5, 6, 7). Under these provisions the settlor, acting alone, cannot cause any distribution to be made to herself; all distributions to her, as well as distribution of one-half of "surplus income" under Section G (3) (R. 43), as all other distributions, are subject to the judgment and discretion of the trustee (Petitioner's brief in support of the petition, p. 13).

The petitioner's contention is that both as to corpus and income, the trustee, on the question of making distribution to Mrs. Wenger, is substantially interested adversely to her; that this interest is more than the "bare legal

interest, such as that of a trustee" which is stated in Treasury Regulations 86, Art. 166-1 (b) (4), Art. 167-1 (b) (3) (set out in respondent's brief pp. 11, 12 and 13) as "never substantial and never adverse."

II.

At page 6 of respondent's brief it is said that the petitioner does not question the propriety of the Board's conclusion that by paragraph G (1) of the trust instrument herein, the petitioner was permitted, with the acquiescence of the trustee to use the income, and if necessary the corpus for needs for which she normally would use the property had no trust been created. On the contrary, the petitioner does question the propriety of that conclusion.

The trust was created expressly for the benefit of the petitioner's children as well as for herself (Section B, R. 38); to make special funds available "in case of necessity for alleviating the needs and wants of [the petitioner] and children in event contingencies as hereinafter set forth should arise" (Section B, R. 38); that the income of the trust "may be available to insure, as far as humanly possible against suffering, want and deprivation by the maker and her children" (Section C 1, R. 38); to protect the children from what they may suffer by reason of certain provisions of their father's will (Section C. 2, R. 38, 39, 40).

We submit that the interpretation placed upon Section G (1) (R. 42) by the Board in its opinion (R. 67) is not correct. Section G (1) authorized (did not direct) the trustee in his discretion to pay such sums as will be sufficient "to alleviate, aid and relieve such beneficiary or beneficiaries from such misfortune or happening" (R. 38)

and these terms should be interpreted and limited by the terms expressing the purposes of the trust in Sections B and C, particularly Section C 1 (R. 38).

If the interpretation placed by the Board (R. 67) on Section G (1) (R. 42) be true, still the Board and the Court below are in error. The Board said (R. 67 line 36):

> "Experience convinces us that the normal life of any individual, no matter how protected, sheltered and circumstanced, contains in every year some occurrence or event which would fall within one of the conditions described."

If this is true, it would not necessarily involve the distribution to Mrs. Wenger of the whole income and corpus in any one year in the proper exercise of discretion by the trustee for the purpose of "alleviating," "aiding" and "relieving" Mrs. Wenger. Nor would it justify payment of the whole income and corpus to Mrs. Wenger, for if the events calling for distribution are sure to happen every year to every one, they will happen to the four children as well as to Mrs. Wenger; hence the money distributed should go to five persons instead of all to one. Sections 166 and 167 of the Revenue Act of 1934 make the settlor chargeable with the income of the part only of the corpus which may be revested in the grantor, and with the part only of the income which may be distributed to the grantor.

We submit that under Section G (1) (R. 42) Mrs. Wenger could use income only to the extent that the trustee might allow, and that the allowance must be limited by what in his judgment would be sufficient to alleviate, aid and relieve her from accident, sickness, calamity, adversity, bereavement or loss; and that in forming his judgment, the trustee must consider whether

the condition to be relieved amounts to a "need," or a "want," words found in Section B (R. 38), and to "suffering, want and deprivation," words found in Section C 1 (R. 38); and that the trustee's judgment must be formed in view of all the rights and interests of the children and the duty of the trustee to conserve them as gathered from all the terms of the trust instrument.

The respondent contends

(1) That the duty of the trustee to duly protect the interests of the children where payments made by the trustee to the petitioner would reduce the amounts of the trust income and corpus available for the children, does not render him substantially interested adversely to the settlor;

(2) That it is settled that a trustee has a substantial adverse interest only;

(a) if he is himself a beneficiary,

or

(b) if he has some other direct personal interest adverse to that of the settlor (Respondent's brief, p. 7).

We submit that the power of equity to compel a trustee to make good to one beneficiary any impairment of his interest in the trust funds resulting from depletion thereof by unauthorized distributions to another beneficiary does constitute a direct personal interest in the trustee, adverse to such other beneficiary.

It results in a surcharge, by the chancellor, of the trustee's account with the unauthorized distribution at the instance of the injured beneficiary, thus impairing the trustee's private fortune.

It is clear that Sections 166 and 167 are not applicable where the power to revest title to the corpus, or to hold or accumulate income, resides in a person who is adversely interested; there is nothing in these sections to the effect that if such a person is the trustee, he must not only be a person adversely interested, but he also must have the additional qualification of being a beneficiary of the trust. That the status of a beneficiary must be a qualification of such a person if the grantor is to escape the tax, was a provision of early Revenue Acts (*Cf.* Revenue Act of 1924 [43 Stat. 253] sec. 219 (g), (h); of 1926 [44 Stat. 9] Sec. 219 (g), (h); of 1928 [45 Stat. 791] Sec's. 166, 167). The Revenue Act of 1932 (47 Stat. 169) Sec's. 166, 167, dropped the status of beneficiary as the qualification, and adopted as such "a person having a substantial adverse interest," and so it now remains; and thus expressly enlarges the class of persons who may so act in conjunction with the grantor, to include a trustee who may not be a beneficiary.

III.

We submit that the cases cited by respondent in his brief at page 7 do not support his contention that the trustee's duties to the children do not endow him with a substantial adverse interest, and that he has such an interest only if he is himself a beneficiary.

The only decision of the Supreme Court cited is *Reinecke v. Smith,* 289 U. S. 172. The comments in the petitioner's brief in support of the petition for the writ at pages 16 and 17, we submit, show that that case is not in point.

In *Commissioner v. Caspersen* (C. C. A. 3) 119 F. 2d 94, the point here in issue was not considered or decided.

There, a wife granted a fund to her husband as trustee; from the income specific sums were to be paid to the wife, and from the excess of income over these specific payments, in the discretion of the trustee, a fund might be accumulated for the benefit of the minor son of the trustee and the grantor. The question presented was whether the husband-trustee was adversely interested in this excess income because of his liability to support the son. The grantor was also liable for the support of the son, and the husband-trustee was liable for her support. It was said that if these facts motivated the trustee's discretion, it was an influence in favor of, and not adverse to, the grantor. The court also found as a fact that considering all the circumstances of the case, "the trustee's interest was unsubstantial as a motive to induce him to distribute income other than as desired by the grantor-wife."

In *Altmaier v. Commissioner* (C. C. A. 6) 116 F. 2d 162, a husband granted property to his wife as trustee. The income was to be accumulated, invested and added to the corpus during the settlor's life or until his wife's death should she predecease him. Beginning at the death of the settlor, the entire net income was payable to the wife for her life; beginning with the death of the wife, the entire net income was payable to the settlor for his life. Upon the death of both settlor and wife, the trust fund was to be distributed to persons named. The case did not require the consideration of any duty of the trustee to exercise any discretion in making a distribution of income or corpus which involved conflicting interests of several beneficiaries; the questions here in issue were not there presented, considered or decided.

In *Morton v. Commissioner,* 109 F. 2d 47, 51 (C. C. A. 7), the trustee was a commercial trustee receiving $700 in

fees annually for its services; the court found this sum negligible when the size of the income and the corpus was considered, and so did not confer an adverse interest on the trustee; the trustee had power to revoke the trust instrument at any time in the exercise of which, under *Reinecke v. Smith,* the trustee owed no duty to the beneficiary. The income was to be accumulated during the continuance of the trust, and on its termination the accumulated income and all investments thereof were to be paid over to the grantor's daughter, and all the corpus to the grantor, or, if he was not alive, to other specified persons. The trustee had no questions to decide which required the exercise of his discretion and concerned conflicting interests of two or more beneficiaries. The point here in issue was not raised, discussed or decided.

In *Fulham v. Commissioner,* (C. C. A. 1) 110 F. 2d 916, a husband, as grantor, conveyed property to himself and another as co-trustees. The trust instrument provided that until the death of the grantor's wife, the trustees should accumulate the income, and also as follows: "During my [the grantor's] life, the trustees may pay to her [the wife] at any time or from time to time any part or parts or the whole of the principal and/or accumulated income of the trust fund." The trust agreement also provided for payments after the death of the wife, to the grantor's children and their issue. It also provided that a committee of three persons named, might revoke or alter the trust instrument in any way or manner, except that the committee's power to alter so as to revest in the grantor any part or all of the corpus or income was not to be exercised during the life of the wife without her consent. The court emphasized the word "may" in the provision in the trust agreement in the wife's favor. The court said that there was no criterion laid down by the trust

instrument for the guidance of the trustees in making payments to the wife on which she might under any circumstances invoke the aid of a court of equity to compel the trustees to exercise their discretion in her favor. The question of the duty of a trustee in the exercise of his discretion in making distribution to beneficiaries with conflicting interests, and the effect of his obligations arising therefrom was not presented, considered or decided.

In *Helvering v. Evans* (C. C. A. 3) 126 F. 2d 270, the grantor transferred to the Wilmington Trust Company, a Delaware corporation, as trustee, 166 shares of stock of the Journal Company. The trustee was directed to accumulate annually, and add to the corpus income in excess of $20,000 until the accumulations aggregated $1,000,000; but the annual accumulations were not to exceed one-third of the net income of any one year. The settlor during her lifetime was authorized to direct the trustee to set aside portions of the trust funds as "shares" for the benefit of her issue. That direction had never been given. The report of that case in 126 F. 2d 270, does not set out the fact which we take from the report of the case before the Board of Tax Appeals (42 B. T. A. 851) that the trust instrument directed the trustee to pay to the trustor during her life so much of the net income as was not subject to accumulation; and upon the death of the trustor, to distribute the income and the trust fund to the trustor's descendants. The trust instrument, in Section 10, also provided that "if during the continuance of this trust, the income currently payable hereunder to or for the benefit of any beneficiary, together with his or her income from other sources, should be insufficient to properly provide for the support, maintenance, benefit and/or education of such beneficiary and his or her dependents, trustee is authorized and em-

powered, in its sole discretion, to pay over, unto or for the benefit of such beneficiary so much of the principal of any part or the whole of the trust fund from which such beneficiary may then be receiving the income or the benefit thereof as may be required to make up such insufficiency of income. * * *"

The court said the term "benefit" meant "whatever promotes welfare; advantage, profit." The authority for distribution was not only for the "benefit" of the beneficiary, but also for the "benefit" of his or her dependents (not descendants).

Under the provisions of section 10, distribution was directed to be made to or for the beneficiary [*ie.* the settlor] for the "benefit" of her and her dependents of any part or the whole of the principal of the trust fund. The court, saying that "benefit" meant "whatever promotes welfare; advantage, profit", held that under that term the trustee was authorized to make distribution to the grantor "almost without limit." There was nothing in the trust instrument requiring the trustee to conserve any part of the trust fund for the benefit of the grantor's descendants and their issue; the question of the duty of the trustee in that regard, and the effect of the obligations arising therefrom, was not presented, considered or decided.

The case of *White v. Higgins* (C. C. A. 1) 116 F. 2d 312, does not support the respondent's contention. There, the settlor was a trustee with power to make himself the sole trustee, and turn over to himself all the trust property if he thought it for his welfare to do so; and thereby terminate the trust. No duty was imposed on the trustee to conserve any part of the trust property for the benefit of any other beneficiary of the trust. At most, if, in the

terms of that trust instrument any such duty could be spelled out, it was so shadowy as not to furnish any substantial ground for anticipating that the trustee would be called to account by any other beneficiary for turning over the trust property to himself. The trust instrument is described at pages 314 and 315 of the report.

At pages 7 and 8 of the respondent's brief, *Stuart v. Commissioner* (C. C. A. 7) 124 F. 2d 772, is referred to. That case decides that a trustee may have a substantial adverse interest; this met the contention that a trustee never could be substantially adversely interested based on the sentences in Art. 166-1 (b) (4), Art. 167-1 (b) (3) of Treasury Regulations 86, reading "A bare legal interest, such as that of a trustee, is never substantial and never adverse." *Stuart v. Commissioner* does not decide that a trustee can have a substantial adverse interest only when he is a beneficiary.

IV.

There is a feature of the trust instrument in this case which, so far as we are aware, makes it unique.

By Section F, the trust is to continue for fifteen years and six months from its date; provided, however, that it may be sooner terminated in one of four ways, viz:

(1) By the consent of the settlor and her four children and the trustee, evidenced by a writing signed by all persons, including the trustee whose consent is required;

(2) By consent of the settlor and the living children and the trustee evidenced by a writing signed by all, including the trustee, whose consent is required;

(3) By the death of all the children prior to the expiration of the 15½ year period;

(4) By the death of the settlor prior to the expiration of the 15½ year period, if, at the death of the settlor, all the then living children shall have reached 35 years of age and shall have received from the trustees under their father's will all the funds of the trusts of that will of which the children are beneficiaries. (For the provision of the trust instrument in this case here referred to, see section F, R. 41, 42. For the provisions of the father's will referred to, see R. 54, 55).

The trustee had a direct personal interest in the continuance of the trust and in the emoluments accruing to him therefrom. To terminate this trust by consent, application by the beneficiaries desiring the termination must be made to the trustee to sign a writing expressing his consent; the trustee may arbitrarily refuse, there is nothing in the trust instrument requiring him to base his refusal on any grounds whatever.

The trustee is entitled to whatever advantage there may be to him in the contingency that the trust will not be terminated by the death of all the children of the settlor.

Therefore, in this particular unique trust instrument, the trustee plainly had a substantial interest adverse to the settlor.

V.

In *Helvering v. Hormel* (C. C. A. 8) 111 F. 2d 1, the trustees were required to pay income up to $2,000 a year to the wife of the grantor as guardian of the grantor's children. It was held that the guardian was accountable to the children for their share of the income, and so had

a substantial interest adverse to the grantor. In the instant case the relation of the trustee to the grantor's children involves essentially the same principles as the relation of guardian and ward.

Respectfully submitted,

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